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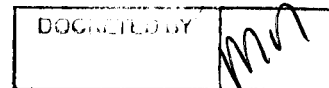
IN THE MATTER OF THE APPLICATION OF
ARIZONA PUBLIC SERVICE COMPANY
FOR A HEARING TO DETERMINE THE
FAIR VALUE OF THE UTILITY PROPERTY
OF THE COMPANY FOR RATEMAKING
PURPOSES, TO FIX A JUST AND
REASONABLE RATE OF RETURN
THEREON, TO APPROVE RATE
SCHEDULES DESIGNED TO DEVELOP
SUCH RETURN.

Docket No. E-01345A-08-0172

Arizona Corporation Commission

DOCKETED

OCT -3 2008

**RUCO'S POST-HEARING BRIEF**

The Residential Utility Consumer Office ("RUCO") hereby submits its Post-Hearing Brief in the above captioned matter. RUCO recommends that the Arizona Corporation Commission ("Commission") deny Arizona Public Service Company's ("APS" or "Company") Motion for Approval of Interim Rate and Preliminary Order.

INTRODUCTION

At the core of APS' interim rate request is a representation by APS' President, Donald Brandt, that he has been advised by the Standard and Poor's ("S&P") credit agency that S&P will be going to committee after the Commission's interim decision and a negative outcome will likely result in a credit downgrade. Transcript at 143, 203¹. When the President of the state's

¹ For ease of reference, trial exhibits will be identified similar to their identification in the Transcript of Proceedings. The Transcript volume number and page number will identify references to the Transcript. Case citations will be footnoted.

1 largest utility makes a statement of that nature, coupled with the potential negative
2 consequences if the Company's credit rating is downgraded to non-investment status, there is
3 certainly reason for pause and concern.

4 However, the statement and the concern must be considered in the context of the entire
5 record. The record in and of itself does not support the conclusion that the Company will be
6 downgraded in the absence of interim relief. On the contrary, the evidence in the record
7 supports the conclusion that only one of the three ratings agencies is even considering a
8 downgrade, and that decision is unlikely to happen prior to the Commission's final decision in
9 the rate case. Moreover, given the nature of the Company's request, good public policy does
10 not support the Company's request in the absence of uncontroverted supporting evidence.
11 The Commission should deny the Company's request for interim relief.

12 **BACKGROUND**

13 The Company filed its last rate case on November 4, 2005. Decision No. 69663 at 3.
14 On January 6, 2006, while that rate case was pending, the Company filed an application for
15 emergency interim rate relief. Decision No. 68685 at 2. The Company claimed that it was
16 experiencing a substantial operating cash flow deficiency and that interim rate relief was
17 necessary in order for the Company to recover its purchased power costs on a timely basis.
18 Id. at 4, 7. The Company further claimed that in the absence of interim relief, it was likely that
19 APS would be downgraded to non-investment, "junk bond" status for the first time in one
20 hundred years. Id. at 4.

21 In Decision No. 68685, the Commission concluded that an emergency did not exist. Id.
22 at 23. The Commission did, however, agree to modify the Company's Power Supply Adjustor
23 to allow the Company to collect additional purchased power and fuel costs. Id. at 24.
24 Ultimately, the Commission authorized a \$322 million increase in the Company's gross annual
revenues. Decision No. 69663 (docketed on June 28, 2007) at 68.

1 The Company's credit rating was not downgraded as a result of the Commission's
2 treatment of the Company's last interim request or the Commission's final decision in the
3 Company's last rate case.

4 On May 2, 2008, the Company filed a notice of intent to increase its equity. Decision
5 No. 70454 at 2. The Company's parent, Pinnacle West Capital Corporation indicated that it
6 intended to infuse a total of up to \$400 million into APS in 2008. Id. at 2. APS indicated that it
7 expected to have a \$400 million annual cash flow shortfall due to a difference between the
8 funds received from operations and its capital needs. Id. at 1. The Company claimed that the
9 infusion was necessary for it to maintain investment grade credit ratings and to improve its
10 financial stability. Id. at 1 and 2. The Commission authorized the equity infusion provided it
11 was made on or before December 31, 2009. Id. at 4.

12 On or about March 24, 2008, APS filed its pending application for a rate increase. APS
13 filed its amended application on or about June 2, 2008. Among other things, APS is
14 requesting a net increase in rates of \$278.2 million. Amended Application in Docket No. E-
15 01345A-08-0172 at 3.

16 On June 6, 2008, APS filed its Motion for Approval of Interim Rate and Preliminary
17 Order. APS is requesting that \$115 million of its permanent request be approved on an interim
18 basis. The matter was scheduled for hearing, and the hearing took place from September 15,
19 2009 through September 19, 2009.

20 **THE COMMISSION SHOULD DECLINE TO FIND THAT AN EMERGENCY EXISTS**

21 The Company believes that its current financial situation would constitute an
22 "emergency." Motion at 6. The Company does not believe an emergency finding is a legal
23 requirement for interim relief in Arizona. More specifically, the Company believes that the
24 "...threat to APS' credit ratings during the duration of the Company's general rate case, would
standing alone and without consideration of the other circumstances ...constitute a lawful basis

1 for a finding of an "emergency". Id. APS, through its witness, Charles J. Cicchetti explains
2 the emergency as a "customer emergency". APS 12 at 13. According to APS, a customer
3 emergency will result in much higher rates over time because of the higher credit cost to the
4 Company from a downgrade . Id. The Company's legal argument is flawed, contrary to
5 Arizona case law, and should be rejected.

6 The emergency exception should be narrowly construed, and the Commission should
7 not base a finding of an emergency on what amounts to speculation about rating agencies'
8 future actions.

9
10 **A) THE EMERGENCY EXCEPTION SHOULD BE NARROWLY CONSTRUED**

11 The Arizona Constitution protects consumers by generally requiring that the
12 Commission only change a utility's rates in conjunction with making a finding of the fair value
13 of the utility's property.² However, Arizona's courts recognize that, "in limited circumstances,"
14 the Commission may engage in rate making without ascertaining a utility's rate base.³ The two
15 limited circumstances identified by the courts are the changing of rates pursuant to a
16 previously-established adjustor mechanism, and the establishment of interim rates when an
17 emergency exists.⁴

18 The provisions of Arizona's Constitution should be liberally construed to carry out the
19 purposes for which they were adopted.⁵ Conversely, exceptions to a constitutional
20 requirement should be narrowly construed.⁶ The Commission's authority to establish interim
21 rates is limited to circumstances in which 1) an emergency exists; 2) a bond is posted

22 ² Arizona Constitution. Art. XV, § 14; *Simms v. Round Valley Light & Power Company*, 80 Ariz. 145, 151, 294
23 P.2d 378, 382 (1956); see also *State v. Tucson Gas*, 15 Ariz. 294, 308; 138 P.781, 786 (1914); *Arizona*
Corporation Commission v. State ex rel. Woods, 171 Ariz. 286, 295, 830 P.2d 807, 816 (1992).

24 ³ *Residential Utility Consumer Office v. Arizona Corporation Commission*, 199 Ariz. 588, 591 ¶11, 20 P.3d 1169,
1172 (App. 2001).

⁴ Id.; *Scates v. Arizona Corporation Commission*, 118 Ariz. 531, 578 P. 2d 612 (App. 1978) ("Scates").

⁵ *Laos v. Arnold*, 141 Ariz. 46, 685 P.2d 111 (1984).

⁶ See *Spokane & I.E.R. Co. v. U.S.*, 241 U.S. 344, 350, 36 S.Ct. 668, 671 (1916) (an "elementary rule" that
exceptions from a general policy embodied in the law should be strictly construed).

1 guaranteeing a refund if interim rates are higher than final rates determined by the
2 Commission; and 3) the Commission undertakes to determine final rates after making a finding
3 of fair value.⁷ The Arizona Attorney General has opined that an emergency exists when
4 "sudden change brings hardship to a company, when a company is insolvent, or when the
5 condition of the company is such that its ability to maintain service pending a formal rate
6 determination is in serious doubt."⁸ APS argues that the Commission has historically
7 exercised wide latitude in determining when an emergency exists. Motion at 19-20. However,
8 as discussed above, Arizona courts would likely narrowly interpret the Commission's authority
9 to determine that an emergency exists and that an exception to the requirement to set rates
10 only upon making a finding of fair value is justified. Essentially, the Commission should not
11 use the "emergency" exception liberally as an excuse to set aside the rule of finding fair value
12 when setting rates.⁹

13 **B) RATING AGENCY COMMENTS DO NOT CREATE AN EMERGENCY**

14 The Commission's constitutional duty is to set just and reasonable rates for public
15 service corporations.¹⁰ The general theory of utility regulation is that authorized revenue
16 should be sufficient to meet a utility's prudent operating costs and to give the utility an
17 opportunity to earn a reasonable return on its investment.¹¹

18 APS claims that it faces an "emergency" arising from the threat of a credit downgrade.
19 APS believes that at least one rating agency is on the brink of downgrading the Company's
20 credit rating to junk status. Regardless of whether APS' perceived threat of imminent
21 downgrade is real or not, RUCO does not believe that the Commission should ignore its
22 constitutional responsibilities by setting rates based on the anticipated reaction of credit rating

23 ⁷ 199 Ariz. at 591, ¶12, citing *Scates*.

24 ⁸ 71-17 Opinion Arizona Attorney General at 50. (1971).

⁹ Arizona case law and the Attorney General Opinion 71-17 set forth the legal parameters within which the Commission should act when considering emergency rate relief.

¹⁰ Arizona Constitution Art. XV, § 3.

¹¹ *Scates v. Ariz. Corp. Comm'n*, 118 Ariz. 531, 533-34, 578 P.2d 612, 614-15 (App. 1978).

1 agencies. Instead, the Commission should focus on the "fundamentals" of setting rates to
2 allow recovery of prudent costs and an opportunity for a fair return. The Commission should
3 maintain its usual goal of setting rates that are fair to ratepayers and that preserve the financial
4 health of the utility, rather than attempting to read tea leaves by attempting to second guess
5 how a credit rating agency will react.

6 Even if the Commission were to permit rating agencies to influence the rate setting
7 process, it is not clear that a downgrade to non-investment status is imminent as APS
8 suggests. There are three major rating agencies – Standard and Poors, Moodys and Fitch. S-
9 2 at 3. APS has the lowest investment grade rating with only one rating agency – Standard
10 and Poors. Id. APS' rating is two grades above non-investment grade with Moody's and Fitch.
11 Id. Moreover, Moody's just upgraded APS' outlook from negative to stable (July 25, 2008).
12 Transcript at 901, S-2 at 10. This upgrade places Moody's on the record as recently being
13 "favorable" towards APS. Id.

14 Moody's and Fitch would have to downgrade APS two grades to place it in non-
15 investment status. According to Staff witness David C. Parcell, a two-grade downgrade at one
16 time is uncommon. Id. It would even appear less likely to occur during the pendency of a rate
17 case. It only makes sense that Moody's and Fitch (and S& P for that matter) would wait until
18 the permanent case was decided
19 before making a two-step downgrade. It is also noteworthy that APS has not claimed that
20 Moodys and/or Fitch have indicated a downgrade is imminent during the pendency of the
21 current rate case.

22 Nonetheless, the Company claims that the ratings agencies have made it clear that the
23 Company must maintain an FFO/debt ratio within at least the 18-20% range to stay within the
24 current investment grade. APS-2 at 26. There are several reasons why the Commission
should not be influenced and/or persuaded by this argument.

1 First, APS was asked by Staff to calculate the impact on the Company's FFO/debt ratio
2 given various scenarios of interim and permanent rate increase. S-1 at 20. APS' response to
3 the scenario where the Commission does not approve interim rates but does approve a 50%
4 base rate increase with rates effective October 1, 2009, showed estimated FFO/debt ratios of
5 23.0% for 2008, 18.7% for 2009 and 18.5% for 2010. In the other scenarios where APS does
6 not receive interim relief the estimates for 2008 – 2010 all result in FFO/Debt ratios above
7 18%. Id. APS' FFO/debt ratios are not in danger of going below the 18% benchmark if interim
8 relief is not granted.

9 Second, the Company focuses its argument on its FFO/debt ratio. However, the
10 FFO/debt ratio is only one financial metric that the ratings agencies use in rating companies.
11 The FFO/debt ratio is not by itself representative of how the rating agencies establish rates. S-
12 2 at 3. S&P analyzes financial risk both quantitatively and qualitatively. S-2, Attachment 2 at
13 2. The quantitative factors include three financial ratios – FFO/Debt(%), FFO/Interest(x), and
14 Total debt/capital (%). Id. at 3. Moody's and Fitch also consider multiple factors in
15 establishing ratings. S-2 at 7. The undisputed evidence in this case is that the major ratings
16 agencies rely on more than one financial metric in establishing ratings. In fact, according to
17 the agencies, there are a whole set of criteria that each ratings agency considers. Id. The
18 Commission should not be persuaded by the Company's argument that its rating hinges on
19 only one financial metric – the FFO/debt ratio.

20 Third, and perhaps most important, the latest reports of the ratings agencies on APS
21 are positive and do not suggest that a downgrade is imminent. In S&P's June 25, 2008 ratings
22 report, S&P reported that APS' outlook is "stable" and that its business profile is "strong."
23 RUCO-2 at 2. While recognizing that APS faces "significant regulatory challenges", S&P
24 reports that APS continues to benefit from a strong service territory, a reasonably balanced
power supply and a good PSA. Id.

1 In Moody's July 5, 2008 report, Moody's listed APS' FFO/debt¹² ratio for 2005 – 2008 as
2 follows:

3 2005 14.5%,

4 2006 19.0%,

5 2007 18.3%,

6 1Q2008 19.6%.

7 S-5 at 1. According to Moody's, "A downgrade could result if Moody's expects a sustained
8 weakening of financial metrics, if for example, the ratio of CFO pre-W/C/debt would remain in
9 the mid-teens for an extended period." Id. at 5. In other words, given APS' historical FFO/debt
10 ratios, a downgrade is unlikely in the foreseeable future, and at the very least is not imminent.
11 In addition, Moody's like S&P and Fitch, rates APS' outlook as "stable". Id. at 1, S-2 at 10.

12 The evidence in the record in support of interim rates is thin. The Commission should
13 not consider extraordinary relief unless the evidence in the record clearly and uncontrovertibly
14 supports the imposition of an exception to Arizona's Constitution. The courts of this state have
15 made it clear that exceptions to the Constitution's fair value requirement should be construed
16 narrowly and only when the circumstances are extraordinary. A veiled threat by one rating
17 agency which is not only inconsistent with its own written report but inconsistent with the
18 reports of the other two major rating agencies, hardly rises to the level of evidence necessary
19 to support interim rates. The Commission should reject the Company's request.

20 **GOOD PUBLIC POLICY DOES NOT SUPPORT INTERIM RATES**

21 This case is more than just consideration of interim rates. APS, like many utilities in
22 Arizona, is unhappy with the current regulatory paradigm. APS complains that regulatory lag
23 has impeded its ability to timely recover its costs and has placed it in financial peril. APS-11 at
24

¹² Moody's rating methodology equates CFO pre W/C to FFO in the Global Regulated Electric Utilities Methodology. S-5 at 1.

1 1-2. Requests for interim relief are becoming more common in rate cases and is one of
2 several mechanisms that are being used to reduce regulatory lag and side-step the State's
3 Constitutional mandate. Interim/emergency rates, automatic adjustors, single issue
4 ratemaking, decoupling mechanisms, etc. are all ways to reduce regulatory lag and side-step
5 the Constitution's mandates. APS sees regulatory lag as a problem and this case as an
6 opportunity to combine with the Commission to come up with a solution – or as APS refers to it
7 - a "decision model" to meet the state's energy future. APS-11 at 2. In reality, interim rates
8 and the other schemes mentioned above shift the risk from the shareholders to the ratepayers
9 and create a slippery slope that could easily result in monopolies that operate in the absence
10 of effective regulation.

11 Regardless of the perceived flaws in Arizona's regulatory process, the place to have the
12 discussion is not in a single rate case but in a generic docket where the public and the entire
13 regulatory community will have an opportunity to participate. The issue affects the entire
14 regulatory community as well as the public and not just the participants in this single case.
15 The examination and potential improvement of Arizona's regulatory process should not be
16 done piecemeal.

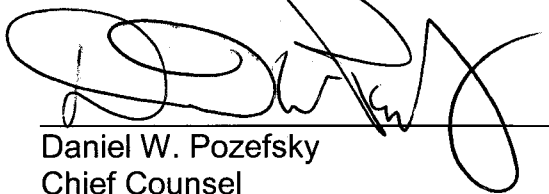
17 There are important policy considerations when attempting to implement a "decision
18 model" to meet the states energy needs. Implementing regulatory schemes such as interim
19 rates that shift the risk from shareholders to ratepayers is not an appropriate template to meet
20 the states energy needs. Good public policy requires, at a minimum, an in-depth examination
21 by all the interested parties, and not just the parties in this rate case to achieve a decision
22 model that meets the state's energy needs.

1 **CONCLUSION**

2 RUCO believes that the Commission should not rely on speculation about rating agency
3 downgrades as the basis for relief. The Commission should consider the entire record and
4 focus on what the rating agencies are saying in their reports and not on hearsay piled on top of
5 hearsay. Based on what the ratings agencies are saying in their reports, there is no reason to
6 believe that a downgrade by any one of the major agencies is imminent. A downgrade prior to
7 the Commission's decision in the permanent case does not appear likely or even make sense
8 based on the rating agencies reports.

9 APS has successfully used the threat of a downgrade to obtain some form of relief in
10 several instances since it filed its last rate case. Since APS has been so successful using this
11 threat, it seems unlikely that the Company will stop using this argument in the future. It is bad
12 public policy to bail out a Company based on threats of how Wall Street will react to a decision
13 declining interim relief by the Commission. As our Attorney General said "... interim rate relief
14 is not proper merely because a company's rate of return has, over a period of time,
15 deteriorated to the point that it is unreasonably low." 71-17 Opinion Arizona Attorney General
16 at 50 (1971). The Commission should deny the Company's request for interim relief.

17 RESPECTFULLY SUBMITTED this 3rd day of October 2008

18
19 
20 Daniel W. Pozefsky
21 Chief Counsel

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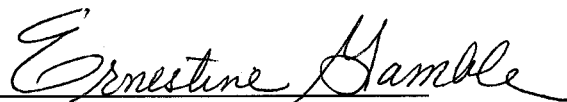
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